

The Revival of *Mudharabah* Contract: A Proposed Framework

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Abstract

Mudharabah is a profit-sharing partnership agreement of a business venture to carry out economic activities. Despite its potential socioeconomic benefits to the parties involved and to the society, the application of *mudharabah* is limited to engineered Islamic finance products which transform the conventional financial products into Shari'ah-compliant ones. We argue that, in order to realise the *mudharabah* true potentials, among others, the *mudharabah* contract needs to be revived. The purpose of this study is to propose a framework in reviving the *mudharabah* contract between the *sahibul mal* (capital provider/investor) and the *mudharib* (entrepreneur). The research methods used in this study are library research and content analysis. As a result, agency theory is recognised to be very relevant to the *mudharabah* contract. To revive the *mudharabah* contract, *tahaluf* concept (Islamic treaty with compliance with Shari'ah) is identified as the most suitable concept to be adopted. This proposed framework serves as guidance in formulating the data collection strategy from different perspectives i.e. from *sahibul mal*, *mudharib*, Shari'ah advisors and academicians.

Keywords: *Mudharabah*, contract, Aqad, framework, revive

1. Introduction

The financial domain in entrepreneurship ecosystem is provided by private or government-linked institutions and banks that extend financial assistance to the entrepreneurs. The current embedded financial capitalism which focuses on wealth and consumption maximization creates imbalanced state and self-destructive ecosystem. In contrast, values in Islamic economy urge moderation in material quests and thoughtful when making private decisions on public good, in addition to pragmatism. There are also philanthropies whose intention is to help the poor (Siddiqi, 2008), or angel investors who would risk their own money and benefit some returns while helping others, through investing in entrepreneur's income generating activities. Unfortunately, there are some issues surrounding this situation, whereby not all poor who received the capital are interested in entrepreneurship (Aliber, Kirsten, Maharajh, Nhlapo-Hlope, & Nkoane, 2006; Gyebi, Owusu & Etroo 2013). In addition, some capital receivers are too poor that they want to only utilise those capital raised for consumption rather than business activities (Fairbourne, Gibson, & Dyer, 2007; Goral & Akgoz 2017). The microfinance institutions are also often charging very high rates (Chhay, 2011) which burdening the budding entrepreneurs.

On another notes, an Islamic profit-sharing; *mudharabah*, is a contract between investor and entrepreneur. In *mudharabah*, the profit accumulated resulting from business activities must be shared on the predetermined contractual ratio and only the investor bears all economic losses so long the entrepreneur is doing the business uprightly (Kwon, 2007; Garaeva & Ahmetzyanov 2018). This is a very fair model as the entrepreneurs are not strained, yet place reasonable sense of responsibility to make profit and share it with the investor. The entrepreneur also cannot use the capital for consumption as the investor is following the business performance after the disbursement of capital. *Mudharabah* could be one of the best solutions which cover at least financial, support and human capital domains. Since *mudharabah* is thus far only contracted as part of financial engineered products and fairly known by the investors and entrepreneurs, it is timely that its true potential should be tapped through direct *mudharabah* contract implementation via improvements on pure *Mudharabah* contract which should solve the agency problem and enhance relationship between the (angel) investors and the entrepreneurs.

The objective of this paper is to propose a framework in reviving the *mudharabah* contract between the *sahibul mal* (capital provider/investor) and the *mudharib* (entrepreneur) in a pure investor-entrepreneur relationship context. This framework will be used in conducting a library and field research in developing an improved *Mudharabah* contract template for future use.

2. Research Methodology

In order to achieve the objectives outlined above, we used qualitative method; library research and content analysis on *mudharabah* and related theory and approach to explain the relationship between investor and entrepreneurs involved. This study is conducted based on these assumptions:

- a) The investors to have positive attitudes to offer Pure *Mudharabah* if fair, clear and flexible *Mudharabah* contracts are in place.
- b) The entrepreneurs to have positive attitudes towards delivering responsibilities in Pure *Mudharabah* if fair, clear and flexible *Mudharabah* contracts are in place.
- c) Pure *Mudharabah* is operationalisable when parties involved in the legally binding *Mudharabah* contracts have positive attitudes towards conforming to the fair, clear and flexible terms and conditions of the contract.

3. Selected Theory and Concept

3.1 Agency Theory

Jensen and Meckling (1976) introduced agency theory in an organisation whereby principal that is the owner, investor or shareholder of the company has to engage with the managers as their agent to manage and perform tasks for the business on their behalf. The agency costs arise when both the principal and agent have conflicting self interests. The principal's interest is for the agent to maximise wealth of the business venture, while the managers' interest is to maximise leisure on job, offer special dealing with their preferred clients, outright theft, take high risk activities and so on, which in turn will increase expenses and reduce profit of the corporation (Ge, et.al 2018).

Based on this theory, the principal mentioned has very similar role as *sahibul mal* in *mudharabah* contract, who provides the capital into the business. On the other hand, the agent in the agency theory also has similarities with the *mudharib* in *mudharabah*. This is such because the *mudharib* has the responsibilities to manage the business as the basic requirements of *sahibul mal* which are to grow the capital and earn profit with business activities which are allowed by the Shariah.

As the profit will be shared between the *sahibul mal* and the *mudharib*, the agency cost can be reduced as both parties are aiming the same goal; to maximise the profit of the business venture. The agency problems however, arise when both parties have different limitations, whereby the *sahibul mal* needs to bear fully the business losses due to unfavourable economic condition, while the *mudharib* needs the trust from the *sahibul mal* that he/she can execute the business activities independently without any *sahibul mal*'s intervention. To ensure that the *mudharib* is not taking actions and making decision with negligence, some penalty to bear the losses by the *mudharib* should be clearly written in the contract, understood and agreed. Likewise, the *sahibul mal* must also aware of his/her limitation of refraining from intervening in making business decisions and actions. For these similarities, Agency Theory is obvious to be very related to *mudharabah* contract. Among others, some studies that advocate with the relevancy of Agency Theory with *mudharabah* include those done by Abdul-Rahman, Abdul Latif, Muda, and Abdullah (2014), Samad, Gardner and Cook (2005) and Khalil, Rickwood and Murinde (2002).

3.2 Tahaluf Concept

Tahaluf Siyasi (political treaty) was discussed in length on how it is related to the benefits of society in general and benefits to political unity in particular (Mohd Syakir, 2015; Fiscal, 2018). In the discussions, six principles, four features and six conditions are elaborated. They first principle is defending the truth; second, the principle of maintaining peace; third, the principle of compliance to agreement with Allah SWT; fourth, the principle of upholding an agreement; fifth, the principle of being firm with non-Muslims, and sixth, the principle of seeking *mardhatillah* (Allah's pleasure) as the ultimate goal.

As for the features of *tahaluf siyasi*, there are four features drawn. First, there is tenure of the agreement; second, the agreement is void if terms are violated; third, agreement is clearly documented and fourth, the agreement is sealed with Allah SWT as witness and source of strength. In terms of conditions of *tahaluf siyasi*, there are six conditions to satisfy. First, loyalty; second, sincerity; third, smart management; fourth, firm stance; fifth, *ukhuwah* (maintaining good relationship) and sixth, having confidence in the treaty. When comparing the *mudharabah* with *tahaluf* concepts, there are a lot similar situations in both of the concepts. While adoption of all of *tahaluf* concept is best, some possible

concepts which *mudharabah* can adopt from *tahaluf* concept include the principle of fairness and most of the features. Smart management as a condition of *tahaluf* can be adopted in selecting *mudharib* to ensure conditions to profit in *mudharabah* are met. Figure 1 shows the comparisons and adoption of the two concepts.

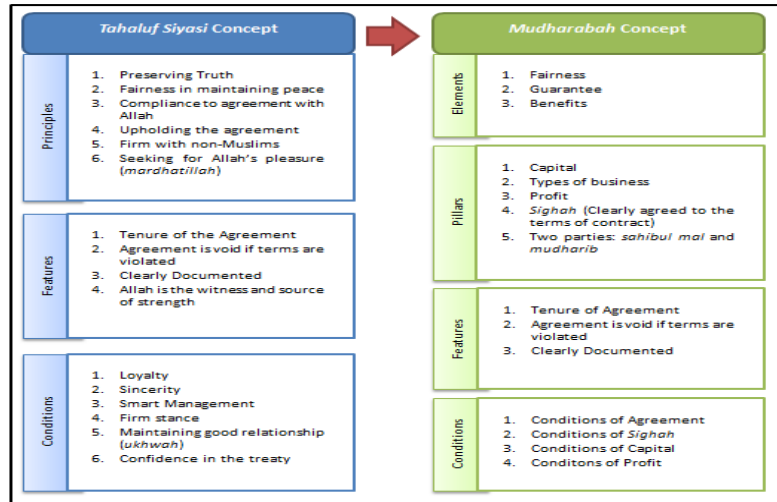


Figure 1

4. Proposed Framework to Revive Pure Mudharabah Contract

The revival of *mudharabah* contract is vital to increase the success of its implementation. Based on the discussions above, we therefore propose conceptual framework which combines the *mudharabah* concept with Agency Theory (Jensen & Meckling, 1976) and *Tahaluf* Concept (Mohd Syakir, 2014). The following figure is the proposed framework.

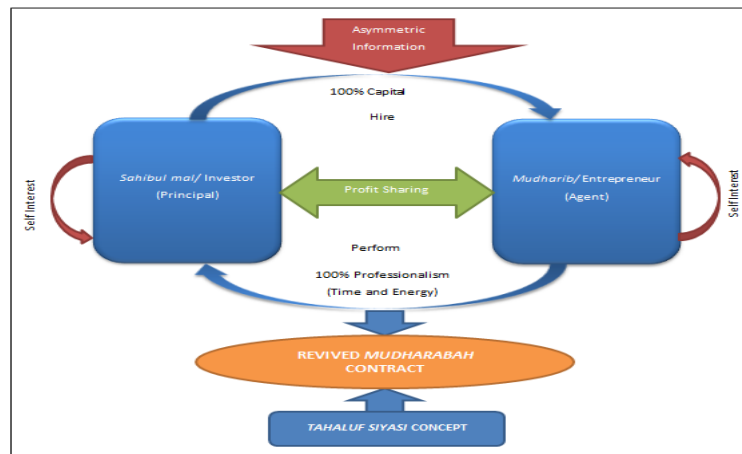


Figure 2

5. Conclusion

As part of the efforts to contribute to this transformation, the revival of the *mudharabah* contract is imperative as the current contract revolves around banking regulations. To revive the contract, agency theory and *tahaluf* concept are incorporated into the framework, to ensure all the important terms are included in the agreement. By incorporating agency theory to the framework, the similarity in the relationship may guide the *mudharabah* contract writing to include the measures to solve expected agency problems which would arise in the *mudharabah* implementation.

The adoption of *tahaluf* concept such as the principle of fairness to maintain peace, features which include tenure of the agreement, voiding the agreement when the terms are violated and documenting the agreement clearly, as well as smart management condition of the *tahaluf* concept serve as a reference in *mudharabah* contract revival in considering the terms of the contract. The adoption of the *tahaluf* concept is hoped to preserve the spirit and realise the real substance of *mudharabah*. This proposed conceptual framework will be used as a guide when collecting data from interested parties in *mudharabah* such as investors, entrepreneurs, Shariah advisors and academicians. The data collected from these potential informants will be analysed to formulate a revived *mudharabah* contract.

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